

Navigating Volatility and Distress

The quiet before the storm

November 2019

Foreword

The longest bull-run since the Second World War may be coming to an end. There are increasing indications that a number of sectors are experiencing rising levels of distress, driven to some extent by macroeconomic factors, but also by technology disruption, increasing global trade tensions and, in the case of the UK, the additional impact of Brexit.

The potential slowdown comes at a time when both Private Equity and the Institutional (non-bank) lenders have at their disposal record levels of dry powder, which together with persistently low interest rates have put borrowers in the driving seat when structuring or restructuring their financing arrangements. With leverage at close to record levels, cov-lite and wider document flexibility becoming the norm, we are living in interesting and unusual times.

These new dynamics mean that when the downturn arrives, while some aspects of turnaround and restructuring will remain the same, others will be different. The prevalence of cov-lite loans, and a very different mix of lenders now financing businesses, means how restructurings are developed and implemented will change, while the spectre of technology disruption means sorting out the financing will not necessarily be sufficient to fix the problem.

For Deloitte things are different - our M&A business is as busy as our Restructuring team. While stress has so far been limited to a few specific sectors, we are having an increasing number of conversations with clients, ranging from Fortune 500 to Private Equity, about preparing for a "softening".



Richard Bell

Managing Partner,
Financial Advisory
+44 161 455 6325
ribell@deloitte.co.uk



Jarek Golebiowski

Navigating Volatility &
Distress Lead Partner
+44 20 7007 2558
jgolebiowski@deloitte.co.uk

Economic slowdown

Global growth is slowing at a faster pace than expected and most forecasters see the risks to growth as lying on the downside. The inversion of the yield curve in the US and UK has stoked fears of recession; at least in the US it has a good track record of anticipating recessions. The German economy has seen a marked slowdown driven by weakening global demand and trade tensions. The weakening of the Chinese Yuan, which by August was above the crucial level of seven to the dollar, has increased the risk that the current trade war will turn into a currency war.

Most forecasters expect the economies of the West to show continued, but sluggish, growth over the next two years but the risks of recession are rising.

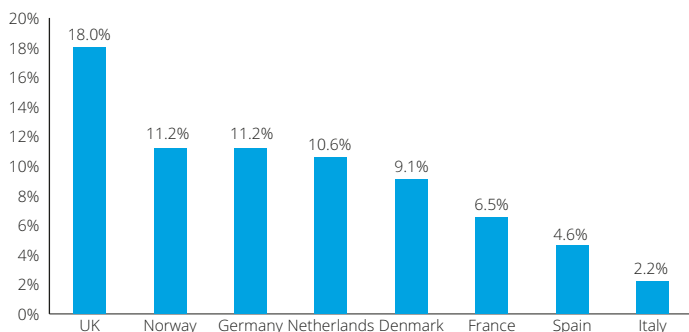
- German and UK economies contract in Q2 2019
- US, UK and Germany yield curves invert in August



Technology disruption is impacting more and more industries

Meanwhile, the ever-increasing speed of technological change is disrupting many industries. The UK, the world's leading e-commerce economy¹, has seen turmoil on the high streets for several years now and, as e-commerce penetration continues to increase, retailers in other European countries are showing increasing signs of stress.

Online share of all retail sales



Source: bevfi/Office for National Statistics/Fevad/Eurostat/Mintel

"With UK retailers reporting the worst September figures on record, and the switch to online showing no sign of slowing down, reconsidering the role of the physical store has never been more important."

Dan Butters, UK Head of Restructuring Services

The automotive industry appears to be facing a perfect storm. The recent downturn in auto sales, particularly in China, the world's largest market, where sales in the first six months of 2019 were 12% down on 2018², the backlash against diesel, and the inexorable rise of electric vehicles is causing turmoil for the "traditional" OEMs and their supply chains. The rise in electric vehicles in particular, which will render 20%-25% of the components (by value) in a conventionally powered car obsolete, is leading many automotive component suppliers to rethink their business models.

In 2017 Delphi Automotive, via 20+ M&A deals, split itself in two:

- Aptiv, focussed on the future car
- Delphi Technologies, containing the powertrain businesses

A future/legacy split is something that many businesses may need to consider as technology drives ever more rapid change. Such a reshaping of a business will require (potentially significant) funding, in particular where any acquisitions are planned, as the funds raised from the disposal of legacy businesses are unlikely to cover the full cost of any growth-oriented acquisitions.

In times of technology disruption across a number of sectors, M&A has become a critical tool, not just for strategic growth, but also for survival.

"The dizzying pace of technological disruption, coupled with ongoing economic volatility, means the very survival of many companies depends on their ability to respond to evolving customer demands and create business models for the future. We expect strategic deals aimed at acquiring disruptive technologies and products will play a critical role in enabling companies to reorient. The next few years should present considerable opportunities for ambitious and disciplined acquirers to capture these emerging growth opportunities."

Iain Macmillan, Global Head of M&A

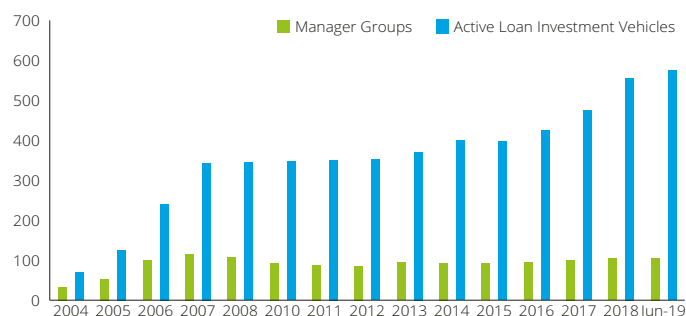
1. bevfi/Office for National Statistics/Fevad/Eurostat/Mintel

2. <https://www.wsj.com/articles/no-turnaround-in-sight-for-china-car-sales-11562757696>

Mountains of money, much of it from alternative lenders, looking for a return, and the rise of cov-lite

Despite these challenges, in this era of perpetually ultra-low interest rates, ever-growing mountains of capital continue to look for a home and a yield. From 2007-2012 PE houses, Direct Lenders and sector-specific funds had \$1.1trn-\$1.3trn of dry powder. As of mid-2019, Preqin was reporting \$2.44trn³ of dry powder globally available to be deployed outside of the regulated walls of banking.

Institutional Investor Group and Loan Vehicle Count



Source: LCD Quarterly European Leveraged Lending Review: 2Q19

And there is investor pressure to deploy it in a world which appears to have become used to reasonably high levels of uncertainty. In 2008/9 we talked about a maturity wall as the refinancing market was shut for a prolonged period.

This time, fund managers have a fund for (almost) every situation, and if they don't, they raise one - the number of loan vehicles in Europe has increased by 45% to 574 since 2015. As the high-yield bond market shut (or became more selective) single funds have stepped in prepared to make \$1bn+ unitranche deals, such as Ares Management's loan to Daisy Group, providing refinancing alternatives in a space previously dominated by public or syndicated markets. The retreat of the high street banks has barely been noticed.

- \$2.4trn of dry powder
- A fund for every situation
- \$1bn+ unitranche deals
- 95% cov-lite in 2019

These mountains of money searching for a return have meant that borrowers have been able to dictate terms, and hence the vast majority of syndicated loans are cov-lite, or even covenant free – 88% in 2018 and 95% in H1 2019.

3. <https://www.ft.com/content/2f777656-9854-11e9-9573-ee5cbb98ed36>

Whilst available capital and competition is putting pressure on Private Equity returns...

From a PE perspective, an impending downturn should bring an increased focus on under-performing assets. Investments made since the financial crisis have seen crystallised losses on around 20% of assets. However, deals made in the run-up to both the 2000-01 and the 2007-08 recessions saw losses on around 40% of investments⁴. Many long-held assets are also more at risk, as their under-performance is often the reason why they have not yet been exited. 1 in 6 assets held by

PE companies have been held for more than 7 years⁵. Getting these assets into the best shape possible, or exiting them, ahead of a downturn should be a priority.

- Crystallised losses on 20% of PE assets since 2008
- Crystallised losses on 40% of investments made prior to last two recessions
- 1 in 6 PE assets held for more than 7 years



4. <https://www.bain.com/insights/global-private-equity-report-2018/>

5. Deloitte analysis

... means that any softening or downturn will have some different characteristics

When borrowers with cov-lite loans hit trouble there may be limited warning signs for lenders, who may only be able to take action very late in the day, if at all. Therefore the timescale to effect any restructuring will be much shorter than before – and largely driven by liquidity. What does this mean?

- Borrowers will have more control. Whilst for corporates and their sponsors this will mean more flexibility to find a solution, for lenders this creates a challenge. If the borrower delays taking action until the last minute, lenders need to be ready to act, and to act fast.
- Managing liquidity will be key – something in our experience many finance teams are not equipped to do on a sustainable basis.
- Restructuring terms will be driven by the providers of new money, be it debt or equity.
- The flexibility in documentation may allow sponsors/ companies to inject capital in ways not originally envisaged.
- There may be significantly more pressure from existing lenders on directors to use their duties as catalysts for action in the absence of covenants.

- Compressed restructuring timetables
- Restructuring terms driven by new money
- Capital injected in unforeseen ways
- Increased pressure on directors

“Last minute (re)action has been, and continues to be, one of the most common features in restructurings. However, in the current environment, where addressing the challenges often requires using a much wider toolkit, combining a balance sheet restructure with radical performance improvement initiatives and bolder use of M&A – leaving things too late really limits the options.”

Jarek Golebiowski, Navigating Volatility & Distress Lead Partner

“You don’t have to look far to find reasons why the financing markets could go into a tail spin. Indeed, maybe the most surprising thing is that they aren’t spinning more right now. The key focus for us at the moment is to make sure that we put in place the right financing packages so that when they do, finance directors and their Boards can rest easy at night.”

Chris Skinner, Head of UK Debt Advisory

Borrowers should also get to know their lenders, although this can be a challenging task. In the sub-investment space the majority of lending in Europe is provided by the increasingly large number of institutional and alternative lenders (aka funds – our Debt advisory practice has interacted with 300+) which in many situations are replacing banks struggling with regulatory requirements. So what does this mean?

- When a company is stressed it is often not clear what strategies are being taken by different representatives of its lending group, as under the same banner funds can deploy many different strategies. So as debt and hedging structures have become more complex, agendas have multiplied.
- Debt trading should be expected – notwithstanding the increasing prevalence of trading restrictions in syndicated deals (up from less than 10% of deals in 2015 to 68% of 2019 deals) – and incoming lenders may have very different objectives, from yield-play to loan-to-own.
- Whilst special situations funds are likely to be disruptive, ask a lot of difficult questions, and occasionally seek to take control, in many situations they help unlock stuck deals and provide new capital where existing stakeholders are unable or unwilling to provide new money.
- At the same time, the flexibility of available capital means that when companies don’t leave it until it’s too late, there are likely to be financiers happy to refinance a “storied credit” or a turnaround case, and not necessarily seek to take control of the business.

However, other features of restructurings will remain the same

- The devil is in the detail – understanding loan documentation, stakeholder dynamics and most importantly the numbers (turnaround plans and cash flows) is critical to a successful restructuring.
- Companies and sponsors often leave things too late, sometimes tactically but often by simply being in denial or over-optimistic. They will most likely have more options when action is taken earlier, which should be in the best interests of all stakeholders.

“Razor-sharp focus on cash generation and a tight grip on cost base are critical self-help measures we increasingly help our clients implement as they seek to improve their capital efficiency and steer away from stress.”

Peter Callas,
Co-Head of UK Value Creation Services



Activists an increasing challenge for listed businesses

Whilst a lot of the above features will be visible in the sub-investment grade space, in the listed universe we should also not forget about Activist investors, who have been operating in the US for several years and have now set their sights on Europe where they have already shaken things up at several FTSE 100 companies. When an activist targets a business they believe to be under-performing, they agitate for change, typically in the form of breakup, disposals or operational improvement, and often request a seat on the board. As our research has found, management teams seeking to avoid the disruptive effect of an activist investor should look at their businesses through an activist or a private equity lens and consider the strategic coherence of the Group and the operational efficiency of the businesses⁶.

"Activist Investors are always on their toes looking for decent businesses that have had short term under-performance, and when the tide goes out those businesses in particular won't be able to hide. Additionally, with increasing interest levels in European businesses – our research shows half the levels of penetration compared to the mature US market for Activists – these phenomena are likely to reinforce themselves."

Dr Jason Caulfield, Global Head of VCS



6. <https://www2.deloitte.com/uk/en/pages/financial-advisory/articles/activist-investor.html>

And downturns also bring opportunities

The other side of the coin is that downturns bring opportunities. They can provide a stimulus for companies to focus on the operational good-housekeeping that may have slipped, or been a lower priority, when growth was the focus. While for agile and opportunistic companies there may also be M&A opportunities either as an acquirer, taking advantage of potentially softening price expectations, or as a seller, disposing of non-core assets to replenish capital/reserves and offload underperforming business units.

"We have seen an increase in the number and quality of turnaround M&A mandates in 2019 and expect this trend to continue in the short to medium term – driven principally by the softening in the broader economy, Brexit uncertainty and also larger corporates seeking to pro-actively exit non-core operations to enable a rebalancing of their strategic focus.

The Special Situations investor community has developed significantly over the last few years with a real wall of money (estimated at over EUR 100bn) allocated to stressed/distressed opportunities. Whilst this is a significant amount of funding to bring to relevant situations, the acceleration of technological advancement across sectors and changing consumer tastes and behaviours will mean that, whilst there will be no shortage of opportunity to deploy this capital, spotting those businesses with real turnaround potential and a clear path of future viability will be critical"

Rob Harding, UK Head of Special Situations M&A

In conclusion

There are increasing signs that a downturn is coming. Investors, borrowers and lenders should prepare for the fact that the dynamics will be different this time. Whilst the array of options available to borrowers is broader, if they act early, the timeframe to deal with challenging circumstances is likely to be compressed.

To prepare for this, we encourage our clients to critically assess (and act) if:

- They have a robust early warning system to anticipate issues (e.g. underperformance leading potentially to profit warning, covenant or liquidity issues)
- The operating model is robust, or radical action needs to be taken to align it to market conditions (e.g. cost relocation, move to digital)

- Cash and capital efficiency is on the regular Board agenda (not just revenue and EBITDA)
- The financing structure is robust, can weather a storm, and has taken advantage of options currently available (e.g. maturity horizons, flexibility)
- The financial stakeholder landscape is well understood (who will support, who may be difficult)
- M&A is considered as both a strategic, but also a tactical tool (to support a turnaround and/or take advantage of market opportunities)
- Critical decisions can be made quickly (e.g. exit from an underperforming operation)

To find out more, please reach out to your Deloitte contact or one of the contacts overleaf.



Contacts

Richard Bell

Managing Partner, Financial Advisory

+44 161 455 6325

ribell@deloitte.co.uk

Jarek Golebiowski

Navigating Volatility & Distress Lead Partner

+44 20 7007 2558

jgolebiowski@deloitte.co.uk

Andrew Grimstone

Global Head of Restructuring

+44 20 7007 2998

agrimstone@deloitte.co.uk

Chris Skinner

Head of UK Debt Advisory

+44 20 7303 7937

chskinner@deloitte.co.uk

Peter Callas

Co-Head of UK Value Creation Services

+44 20 7303 8748

pcallas@deloitte.co.uk

Dr Jason Caulfield

Global Head of VCS

+44 20 7303 4883

jcaulfield@deloitte.co.uk

Dan Butters

UK Head of Restructuring Services

+44 20 7303 6100

dbutters@deloitte.co.uk

Iain Macmillan

Global Head of M&A

+44 20 7007 2975

imacmillan@deloitte.co.uk

Rob Harding

UK Head of Special Situations M&A

+44 20 7007 2514

robharding@deloitte.co.uk

Liam Camburn

Transaction Services Partner

+44 20 7007 3069

lcamburn@deloitte.co.uk

Deloitte.

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